

Testimony

Of

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Senate Committee on Small Business and Entrepreneurship

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S. 1263
and related Small Business Innovation Research (SBIR) Program issues

Madam Chair and Members of the Committee, thank you for allowing me to appear here today.

I am Eugene Watson, currently an SBIR consultant to the University of Wyoming Research Office and to the Wyoming Business Council, the state's economic development organization. However, the observations and opinions I will present to you this morning are entirely my own.

I appear before you as a confessed but unrepentant serial entrepreneur. Over the past five decades, I have participated as a founder in the formation and launch of eight technology-based start-ups. The largest, a \$600 million enterprise with a market cap of over \$1 billion, celebrated its 40th anniversary this year. The most recent three of these start-up ventures received seed capital funding from the SBIR program. In the process of being principal investigator on four Phase I and four Phase II SBIR projects, I was converted from a skeptic to a staunch SBIR program advocate. I learned hands-on that this is a federal program that really works as it was originally intended, and has done so for nearly a quarter century. I am here to urge you to resolutely protect the integrity of this most successful program so that it can continue to be a major component in the nation's effort to stimulate innovative entrepreneurship.

Although I have a short list of recommendations to further improve the SBIR program, for example, adjusting the award guidelines to keep pace with inflation, due to time limitations, I will restrict my comments this morning to a discussion of a major threat to the program that is looming on the horizon in the form of S.1263, inappropriately titled the 'Save America's Biotechnology Innovative Research Act' or 'SABIR Act'. This legislation has been characterized by a former chief counsel for advocacy at the Small Business Administration (SBA) as the first ever legislative attempt to redefine 'small business' to include large businesses – an ominous slippery slope indeed. In essence, the SABIR Act will allow businesses that are majority-owned and controlled by large businesses to compete against the nation's thinly capitalized small business sector for the 2.5% of federal R&D funds reserved for them by the SBIR program. This Act is devised solely to benefit businesses owned and controlled by venture capital organizations, allowing them, for the first time, to participate in the SBIR program – in my opinion, a devastatingly bad idea. It abandons Congress' core definition of a small business established over a half century ago: '**A small business is one that is independently owned and operated**'. Dozens of Federal laws and regulations are based on this logical, clear and concise concept.

The assertion that innovative biotechnology R&D is threatened and needs to be saved is not supported by the facts. A recent PriceWaterhouseCoopers Money Tree Report lists 4Q05 venture capital investment in the biotechnology sector as exceeding \$1 billion; \$4 billion annualized. The FY06 NIH R&D budget is \$28 billion, and total annual U.S. funding for biotechnology R&D across all other organizations, public and private, is certainly in excess of \$50 billion. Contrasting

these expenditures with the SBIR FY06 budget of \$2.2 billion for the eleven participating federal agencies reveals the futility of assigning the role of savior to the SBIR program, were one needed.

But, there's more – the implication that the SBIR program has been off-limits to venture capital participation is wrong, just as untrue as the widely circulated canard that VC-owned companies, previously SBIR eligible, are now disenfranchised. Let's be clear – companies owned and controlled by large organizations, including venture capital partnerships, are not now and have never been eligible for the SBIR competition. Companies with minority venture capital backing have always been eligible to participate in the SBIR competition. And, as of 2005, businesses majority-owned and controlled by venture capital organizations have also become eligible, providing the parent is itself eligible. A Government Accountability Office (GAO) report released in April of this year reveals that since 2002 an increasing number of SBIR awards have been made to firms that have received venture capital. At NIH, such firms have generally received larger awards and a larger total share of available SBIR funds than those companies not VC-backed. And, from FY01 to FY04, the average NIH Phase II award granted to VC-backed firms increased by more than 70% from \$860,000 to \$1.5 million, double the maximum of \$750,000 set by the program guidelines. As a result, VC-backed firms are receiving a greater share of NIH's total SBIR dollars each year – an average of 21% in FY04, up from 14% in FY01. Clearly, SBIR program participation by VC-backed companies, at least at NIH, is robust and growing.

However, to this and many other observers, this trend raises some troubling issues. In many respects, the goals of the SBIR program are at odds with the priorities of the typical venture capital organization. For example, SBIR provides seed capital to high-risk start-up companies whereas VC investments are almost exclusively directed to safer later stage deals. This outcome is not surprising in view of the VC's value proposition to their investors of 'minimize risk, maximize return'. And, although often professing to be the funding source of the start-up companies that will become the gazelles of tomorrow, the facts tell a different story. According to Money Tree, VC investment in start-up companies has, over the past decade, gone from about 20% of distributed funds to less than 2%. As VC-backed firms take an increasing share of SBIR funds, one is provoked to ask 'where will the nation's technology-based start-up ventures find replacement seed capital?'

Equally troubling, particularly to this rural-state resident, is the geographic and demographic concentration of VC invested capital. A recent Money Tree report reveals that in 1Q05, nearly 60% of VC investments went to two states, California and Massachusetts. The top ten states received 85% of total VC funding with the remaining 15% shared by forty states. Fourteen states received no venture capital whatsoever. As a sidebar, I note that ten of the eighteen members of this

committee represent states receiving either one or no VC investment during this period – and this geographic inequality continues to grow.

From these data, it is clear that as VC participation in the SBIR program increases, the little guys, especially those from rural areas, will be crowded off the playing field as it becomes increasingly tipped in favor of VC-backed companies.

The tension between SBIR seed capital and venture capital is dramatic and growing. Venture capital is risk averse; SBIR capital is wide open to risk. Venture capital is inaccessible to start-ups; SBIR is congenial to start-ups. Venture capital, having a five year timeline from entry to exit, is impatient; SBIR capital can be recurring with no time constraints. Venture capital is geographically and demographically concentrated; SBIR capital has no geographic or demographic bias. Venture capital is herd-like (telecom yesterday, nano and biotech today, who knows tomorrow); SBIR is always open to all innovative concepts.

Given these dramatic opposites of missions and priorities, this question must be addressed, “Are the goals of the SBIR program more or less likely to be achieved by allowing an unlimited VC presence on the SBIR playing field?”

In closing I would like to make an urgent appeal to this committee. It is my conviction, as well as that of a number of well-informed observers, that the controversy over allowing VC-owned companies unlimited access to SBIR funds has its origins in the now routine and growing practice at the NIH of exceeding the SBIR program award guidelines, often by millions of dollars. An important component of the genius of the SBIR program as originally conceived was to provide award amounts sufficient to enable small businesses to develop their innovative concepts while at the same time, capping the awards at a level below the threshold of interest of large organizations such as venture capital companies. That this strategy was effective is proved in the breach – only when NIH award levels began to routinely exceed the legislated guidelines did SBIR funding become a target of VC-owned and controlled companies. According to the GAO report, awards above the guidelines now account for more than 70% of NIH’s SBIR dollars. I strongly urge this committee, through its oversight function, to work with the NIH to bring their SBIR awards back into compliance with the legislated guidelines. Doing so will begin the process of resolving some of the critical issues that I and others bring before this committee today.

Thank you, Madam Chair, for providing me with this opportunity to testify.